



OFFICES OF THE COUNTY EXECUTIVE

Douglas M. Duncan
County Executive

Bruce Romer
Chief Administrative Officer

January 31, 2002

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended December 31, 2001. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of Section 33-51(a)(4) of the Montgomery County Code of 1994, as amended.

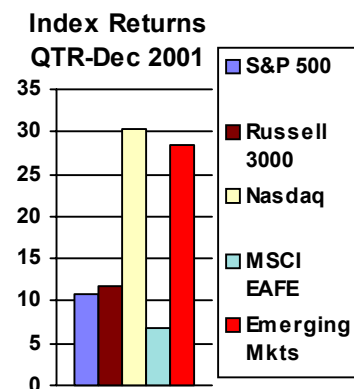
History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were 6,024 active members and 3,989 retirees participating in the System as of June 30, 2001.

Capital Markets and Economic Conditions

The U.S. economy appears to be in the early stages of an economic upturn. Many economists predict that GDP should expand marginally during the first quarter and growth should approach 3 percent by the end of this year. This recovery will have important implications for corporate credit quality and investors' risk tolerance. Recent improvement in the National Association of Purchasing Managers' index and labor market trends suggest that the U.S. economy is entering the transition from recession to recovery. The recession now ending has been very unusual. Recessions have typically been triggered by a monetary squeeze, which forced down demand for new homes, automobiles and other durable goods. This recession, caused by the overinvestment cycle of the late 1990s, forced a collapse in capital spending and a marked inventory correction beginning in late 2000. This decline in business spending was sufficiently deep to provoke a recession, without any decline in household spending.

As depicted in the chart to the right, the December 31, 2001 quarter saw all domestic and most international equity markets, with the exception of the Far East, record strong positive returns, most double digits. Small capitalization and emerging market stocks performed the best.



QUARTERLY REPORT

The most recent rally in stocks produced strong gains in cyclical stocks, such as tech hardware, consumer discretionary and industrials. However, during the rally, 12-month consensus earnings expectations for these sectors were downgraded by 20-30 percent, stretching their valuations even further. Software stocks have also rallied strongly and their earnings expectations have been relatively stable. Investors continue to prefer small to mid capitalization stocks to the well-known larger capitalization companies. The System's investment portfolio is well diversified between large and small companies, as well as growth and value (low price/earnings, low price to book) type investments. Our combined domestic equity performance for the quarter was a return of 11.5 percent, slightly behind our Russell 3000 benchmark index return of 11.8 percent.

Internationally, on January 1, 2002, the European community moved to one currency, the euro. Consensus forecasts are that the dollar will weaken against the euro due to the expectation that capital inflows from Europe will slow in response to less support from the Federal Reserve, a weak U.S. equity market, and a U.S. recovery that will prove sluggish. The MSCI EAFE index, which represents companies located in developed markets, gained 6.9 percent during the last quarter. Emerging markets, as represented by the IFC Emerging Markets Investible Composite, recorded a gain of 28.5 percent. The combined performance of our international equity managers was a return of 9.5 percent compared to the 8.9 percent return of the benchmark index.

In the 4th quarter of 2001 interest rate and corporate credit volatility buffeted the U.S. fixed income markets. The Fed maintained an easy monetary stance, moving the fed funds rate to 1.75 percent by the end of the year. Most intermediate and longer term rates moved higher, impacted by the high volume of new issuance from corporate issuers seeking to lock in low long term borrowing costs and by the record breaking wave of residential mortgage refinancings. The corporate bond sector turned in a strong performance for the quarter, recovering more than what it lost from the 9/11 shock. For the year, the corporate sector outperformed comparable duration U.S. Treasuries by 254 basis points, the best annual performance in thirteen years. The System's combined fixed income performance was .67 percent compared to the Salomon Brothers Broad Index return of .02 percent.

The total return achieved by the Employees' Retirement System's assets for the quarter was 6.9 percent compared to the System's benchmark target return of 6.7 percent. The asset allocation of the System's assets at December 31, 2001 was: Domestic equities 49.6%, International equities 15%, Fixed income 34.5%, Cash .1% and Real estate .8%.

Additions

The primary sources of additions for the ERS include member and County contributions and investment income. The following tables show the source and amount of additions for the quarter ending December 31, 2001 and Fiscal Year to date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr Ended 12/31/01	Fiscal YTD
Employer Contributions	\$ 9.9	\$19.6
Member Contributions	2.9	6.1
Net Investment Income (Loss)	112.0	(54.1)
	\$124.8	\$(28.4)

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, administrative expenses and other costs.

**Employees' Retirement System
Deductions by Type
(millions)**

	QTR ended 12/31/01	Fiscal YTD
Benefits	\$21.2	\$42.0
Refunds	.2	.4
Administrative Expenses	.5	.8
	\$21.9	\$43.2

Outlook

Looking forward we believe the Fed will continue to pursue an accommodative monetary policy, with perhaps another 25 basis points of ease in the early part of the year. Corporate balance sheets and profit margins should improve in 2002 as the economy moves through the current cyclical adjustment, supported not only by the Fed, but also by expansive government spending, lower energy prices and the benefits of the recent wave of mortgage refinancings.

Major Initiatives

During the last quarter, the Board approved 5 percent allocations to Treasury Inflation Protection Securities and Alternative Investments. Investments in the alternative asset class include private equity, real estate, and absolute return strategies. The Board anticipates hiring an alternative asset investment manager and the initial funding to be completed within the next six months. Administratively, the Board reviewed ways to strengthen the operation of the Retirement Savings Plan and Deferred Compensation Plan. The Board also revised the allocation of benefits-related tasks between the Board and the Office of Human Resources.

QUARTERLY REPORT

EMPLOYEES' RETIREMENT SYSTEM STATEMENTS OF PLAN NET ASSETS December 31, 2001

Assets

Equity in County's pooled cash and investments	\$8,558,093
Investments	
Northern Trust	1,745,802,717
State Street	535,067
Aetna	7,131,971
Fidelity - Elected Officials Plan	731,828
Fidelity - Deferred Retirement Option Plan	3,156,792
Total investments	1,757,358,375
Contributions receivable	2,332,327
Fixed assets, at cost:	
Office equipment	111,375
Less: accumulated depreciation	111,375
Net fixed assets	<u>-</u>
Total assets	1,768,248,795

Liabilities

Benefits payable and other liabilities	2,137,620
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Net assets held in trust for pension benefits	<u>\$1,766,111,175</u>
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EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
Quarter Ended December 31, 2001

Additions	
Contributions	
Employer	\$9,890,806
Members	2,886,709
Total contributions	12,777,515
Investment Income	113,606,026
Less investment expenses	1,614,069
Net investment income	111,991,957
Total additions	124,769,472
Deductions	
Retiree benefits	15,853,184
Disability benefits	4,313,221
Survivor benefits	1,031,120
Refunds	182,905
Administrative expenses	488,442
Total deductions	21,868,872
Net increase (decrease)	102,900,600
Net assets held in trust for pension benefits	
At September 30, 2001	1,663,210,575
At December 31, 2001	\$1,766,111,175